



## CONGRESSIONAL BUDGET OFFICE PRIVATE-SECTOR MANDATES STATEMENT

June 18, 1998

### **S. 1301**

### **Consumer Bankruptcy Reform Act of 1998**

*As reported by the Senate Committee on the Judiciary on June 4, 1998*

#### **SUMMARY**

S. 1301 would make many changes and additions to the federal bankruptcy laws. By amending the bankruptcy code, the bill would affect consumer debtors, creditors, private bankruptcy trustees, attorneys, bankruptcy petition preparers, debt relief counselors, and other entities in the private sector.

Certain provisions in S. 1301 that effectuate means-testing in the bankruptcy system would impose new private-sector mandates, as defined in the Unfunded Mandates Reform Act (UMRA). New mandates would be imposed on consumer bankruptcy attorneys and bankruptcy petition preparers.

CBO estimates that the direct costs of new private-sector mandates in S. 1301 would exceed the statutory threshold in UMRA (\$100 million in 1996, adjusted annually for inflation). In 1999, mandate costs could be between \$200 million and \$525 million. Nearly all mandate costs would stem from requirements for consumer bankruptcy attorneys to investigate and verify financial information provided by their clients. Mandate costs on bankruptcy petition preparers, which arise from new consumer protection regulations, would be modest. Mandate costs can be expected to grow in future years. By 2003, direct costs could be between \$300 million and \$950 million.

Bankruptcy attorneys would initially bear those costs, although they would be able to recoup most costs by increased payments from bankruptcy estates. Administrative costs, which include attorneys' fees and costs, receive priority treatment in the bankruptcy system and are generally reimbursed before creditors' claims.

S. 1301 would also provide financial benefits to creditors. By incorporating means-testing into the bankruptcy system, the number of debtors who would be required to file plans of reorganization would rise. As a result, the pool of funds available to creditors for repayment would likely increase. In addition, other provisions in the bill would generate further benefits to creditors. However, benefits to creditors would be partially offset by higher costs of administering the bankruptcy code. In isolated cases, where administrative costs rise by more than the pool of debtors' funds, S. 1301 could impose costs on some creditors.

## **OVERVIEW OF THE BILL AND PRIVATE-SECTOR MANDATES**

Under current law, most individual debtors who seek bankruptcy relief have two options: liquidation (chapter 7) or reorganization (chapter 13). S. 1301 would institute a "needs-based system" for relief under chapter 7 by requiring individuals (and households) who file for bankruptcy to seek debt relief under chapter 13 if they earn a regular income equal to or greater than the national median income (adjusted for household size) and could pay at least 20 percent of their unsecured debts. In chapter 7 cases, debtors' nonexempt assets are sold and distributed by a court-appointed trustee to creditors after deducting administrative expenses. Chapter 7 debtors who are discharged from the system receive a "fresh start" and are not liable for creditors' claims not repaid in full. By contrast, chapter 13 allows debtors to retain their assets in exchange for agreeing to repay creditors out of future income over a period of three to five years. In both chapters, certain debts, such as taxes or those debts incurred fraudulently, may not be discharged.

S. 1301 would amend current law by establishing a system of means-testing provisions for determining the eligibility of consumers for relief under the bankruptcy code. Some provisions in the bill that carry out means-testing would impose new private-sector mandates. S. 1301 would also expand the types of debts that may not be discharged from bankruptcy. In addition, S. 1301 would amend other provisions in federal bankruptcy law, including those covering spousal or child support, family farmers, collection of bankruptcy data, and single-asset real estate debtors.

The Unfunded Mandates Reform Act (Public Law 104-4) defines a private-sector mandate as any provision in legislation that would impose an enforceable duty upon the private-sector except a condition of federal assistance or a duty arising from participation in a voluntary federal program. While a very small portion of debtors is forced into bankruptcy, the bankruptcy process is largely voluntary for debtors, and debtor-initiated bankruptcies are equivalent to participation in a voluntary federal program. Consequently, new duties imposed by the bill on individuals who file as debtors do not meet the definition of private-

sector mandates, and additional costs for debtors would not be counted as direct costs for purposes of UMRA.

Provisions that would impose new enforceable duties on other private entities, such as bankruptcy attorneys and petition preparers (including debtors' attorneys), do meet the definition of a private-sector mandate. Creditors, who are subject to many requirements under the existing bankruptcy code, would face changed duties under S. 1301. Creditors have very specific obligations when they are a party in interest to a bankruptcy case, and most creditors' duties in current law would remain. While S. 1301 would alter the duties of some creditors, in general, the bill would provide creditors with additional rights in bankruptcy cases.

## **PRIVATE-SECTOR MANDATES CONTAINED IN THE BILL**

S. 1301 would impose new private-sector mandates, as defined in UMRA, on bankruptcy attorneys and bankruptcy petition preparers. Bankruptcy attorneys would face new duties to investigate and verify financial information of their clients. Section 102 of the bill would apply Bankruptcy Rule 9011 from Title 11, United States Code, to make bankruptcy attorneys liable for misrepresentations of a debtor's financial condition. Rule 9011 requires attorneys to reasonably verify information provided by debtors and attest, under threat of sanctions and other penalties, that such information is well-grounded in fact. As a result, attorneys in consumer bankruptcy cases would have a duty to investigate and verify documents that their clients must include in petitions for bankruptcy relief. Those documents include a list of creditors, a schedule of assets and liabilities, a schedule of current income and expenditures, statements of projected monthly net income and reasonably anticipated increases in income or expenditures, and other financial information.

S. 1301 would also impose new consumer protection regulations on bankruptcy petition preparers, including attorneys. The bill would require bankruptcy petition preparers to provide potential clients a written notice, prescribed by the Executive Office for the United States Trustees (U.S. Trustees) for the district in which the petition is filed, that contains: a description of chapters 7, 11, 12, and 13, including the costs and benefits of each chapter; a description of services that may be available from nonprofit debt counseling services; and information that would enable the individual to contact nonprofit debt counseling services.

## **ESTIMATED DIRECT COST TO THE PRIVATE SECTOR**

CBO estimates that the direct costs of new private-sector mandates contained in S. 1301 would exceed the statutory threshold in each of the first five years that the mandates were effective. In 1999, new mandates could impose direct costs of between \$200 million and \$525 million. Costs would likely increase over the five-year period and, by 2003, direct private-sector mandate costs could total between \$300 million and \$950 million. Almost all costs would result from additional duties of attorneys to investigate and verify financial information provided by their clients. Because reliable national data on the costs of the bankruptcy system are lacking and the actual costs to attorneys are uncertain, these estimates encompass a broad range.

CBO's estimate excludes: financial transfers between debtors and creditors that would result from enacting S. 1301; costs that could result from delaying distributions from bankruptcy estates to certain creditors due to increased litigation; and potential reductions in debtor repayments in cases where the costs of administration rise by more than payments by debtors.

Costs to Consumer Bankruptcy Attorneys. S. 1301 would make consumer bankruptcy attorneys responsible for verifying the financial information provided by debtors who file for relief. CBO estimates that additional attorneys' costs could be between \$200 million and \$525 million in 1999. By 2003, direct costs could be between \$300 million and \$950 million. These estimates are based on information from the U.S. Trustees about the number of bankruptcy cases expected to be filed over the 1999-2003 period, estimates of debtors who would choose not to file if S. 1301 is enacted, estimates of debtors who would have their cases filed as or converted to chapter 13 cases under the bill's requirements, and estimates of the increased costs to attorneys from performing inquiries into their client's financial condition.

Information from the U.S. Trustees and trends in bankruptcy filings indicate that, in 1999, more than 1.4 million consumer bankruptcy petitions will likely be filed. Of those cases filed in 1999, about 960,000 petitions would be filed under chapter 7 and about 390,000 petitions under chapter 13. CBO estimates that, under S. 1301, 5 percent of chapter 7 debtors (about 48,000) would choose not to file, and 5 percent of all chapter 7 cases would be filed as or converted to chapter 13 cases. Completing investigations of debtors' financial affairs and, for chapter 7 cases, computing debtor-eligibility, would be time consuming. The costs to attorneys could increase by several hundred dollars per case. If attorneys' costs rise by roughly \$150 per case to \$400 per case, applying that increase to a reduced level of chapter 7 cases and a higher number of chapter 13 cases, direct costs in 1999 would be within the \$200 million to \$525 million range.

Mandate costs would increase in subsequent years even if bankruptcy filings drop initially as a result of enacting S. 1301. Bankruptcy filings, after a small decline in 2000, will likely increase between 2001-2003. The U.S. Trustees estimate that in 2003 more than 1.8 million nonbusiness petitions would be filed (about 1.3 million under chapter 7 and 540,000 under chapter 13). Applying the same assumptions about the number of chapter 7 cases not filed for any bankruptcy protection, those converted to chapter 13 cases, and increased attorneys' costs, direct costs in 2003 would be about \$250 million to \$700 million. Furthermore, attorneys' responsibilities for cases filed under chapter 13 in years before 2003 would carry forward because chapter 13 cases have a duration of between three years and five years. Despite a failure rate of 2 out of 3 plans filed under chapter 13, duties for attorneys from cases filed in previous years could add an additional \$50 million to \$250 million, depending on the amount of future litigation.

The costs of new mandates in S. 1301 would initially be borne by bankruptcy attorneys. However, provisions in current law exist for reimbursement of attorneys by increased payments from bankruptcy estates. Attorneys' fees and costs are treated as administrative expenses in the bankruptcy code and are paid out of debtors' estates before distributions are made to creditors. Consequently, the cost of new mandates are ultimately paid out of the pool of funds available to creditors.

Costs to Bankruptcy Petition Preparers. S. 1301 would apply new consumer protection regulations to bankruptcy petition preparers. The bill provides that petition preparers must dispense notices to potential clients about the bankruptcy system, alternatives to the system, and information about nonprofit debt counseling services in the area. CBO estimates that the direct cost of notice requirements would be modest. Notices would be prescribed by the U.S. Trustees for each district and, consequently, little effort would likely be required of bankruptcy petition preparers to comply with the new regulations.

Effects on Creditors. S. 1301 also contains many provisions that would benefit creditors. Most significant for creditors are provisions that would shift debtors from chapter 7 to chapter 13 and provisions that would expand the types of debts that would be nondischargeable. By expanding the types of debts that are nondischargeable, such as many credit card debts over \$400 when incurred within 90 days of filing, some creditors would continue to receive payments on debts that would be discharged under current law. Means-testing in the bankruptcy system would result in more individuals being required to seek relief under chapter 13 rather than chapter 7 and fewer filing for any bankruptcy protection. Because chapter 13 requires debtors to develop a plan to repay creditors over a specified period, the total pool of funds available for distribution for creditors would likely increase. As long as the likelihood of repayment by debtors and the pool of funds increases by an

amount that is greater than the rise in administrative costs, creditors would be made better off under the bill.

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